[redacted]

IN THE

[redacted] the United States

[redacted], INC.

Petitioner,

v.

[redacted] ELECTRONICS CORPORATION,

Respondent.

[redacted] TO THE UNITED STATES
[redacted] FOR THE FIFTH CIRCUIT

[redacted]
[redacted] ASSOCIATION AS
[redacted] OF RESPONDENT

ROBERT C. GOLDBERG
General Counsel
NATIONAL OFFICE MACHINE
DEALERS ASSOCIATION
222 South Riverside Plaza
Suite 2700
Chicago, Illinois 60606
312/648-2300

SAMUEL SCHOENBERG
Counsel of Record

QUESTION PRESENTED

Whether a manufacturer may protect its full service dealers and so assure the continued availability of pro-competitive and efficiency-enhancing services by agreeing to terminate free riders?

TABLE OF CONTENTS

	PAGE
QUESTION PRESENTED	i
TABLE OF CONTENTS	ii
TABLE OF AUTHORITIES	iii
INTEREST OF THE AMICUS CURIAE	1
STATEMENT	2
SUMMARY OF ARGUMENT	4
ARGUMENT	6
THE LEGALITY OF AN AGREEMENT TO TERMINATE A FREE RIDING RETAILER SHOULD BE JUDGED BY THE RULE OF REASON	6
A. Determining Whether An Agreement Is To Be Judged Illegal *Per Se* Or Analyzed Under The Rule Of Reason Requires Careful Consideration Of Its Economic Effects	7
B. Termination Of Free Riders Improves Efficiency By Ensuring The Continued Provision Of Essential Sales-Related Services	10
1. Pre-Sale Educational Services	11
2. The Free Riding Phenomenon	13
3. Protection of Full Service Dealers	14
C. Termination Of Free Riders Prevents An Inefficient Form Of Marketing While Promoting Vigorous Competition	16
1. Interbrand Competition	16
2. Intrabrand Competition	19
CONCLUSION	20

TABLE OF AUTHORITIES

	PAGE
Cases:	
Albrecht v. *Herald Co.*, 390 U.S. 145 (1968)	10
Broadcast Music, Inc. v. *Columbia Broadcasting System*, 441 U.S. 1 (1979)	8,9,19
Business Electronics Corp. v. *Sharp Electronics Corp.*, 780 F.2d 1212 (5th Cir. 1986), *cert. granted*, 107 S. Ct. 3182 (1987)	*passim*
Chicago Board of Trade v. *United States*, 246 U.S. 231 (1918)	8
Continental T.V., Inc. v. *GTE Sylvania Inc.*, 433 U.S. 36 (1977)	*passim*
Dr. Miles Medical Co. v. *John D. Park & Sons Co.*, 220 U.S. 373 (1911)	8
Monsanto Co. v. *Spray-Rite Service Corp.*, 465 U.S. 752 (1984)	9,13,20
Northern Pacific Railway v. *United States*, 356 U.S. 1 (1958)	8
United States v. *A. Schrader's Son, Inc.*, 252 U.S. 85 (1920)	10
United States v. *Arnold, Schwinn & Co.*, 388 U.S. 365 (1967)	15
United States v. *Colgate & Co.*, 250 U.S. 300 (1919)	10
United States v. *Parke, Davis & Co.*, 362 U.S. 29 (1960)	10
Valley Liquors, Inc. v. *Renfield Importers, Ltd.*, 678 F.2d 742 (7th Cir. 1982)	19
Statutes:	
15 U.S.C. § 1	*passim*
Pub. L. No. 99-180, § 605, 99 Stat. 1136, 1169-70 (1985)	9
Miscellaneous:	
Baker, *Interconnected Problems of Doctrine & Economics in the Section One Labyrinth: Is Sylvania a Way Out?*, 67 VA. L. REV. 1457 (1981)	18
R. BORK, THE ANTITRUST PARADOX (1978)	12

	PAGE
Bork, *Vertical Restraints: Schwinn Overruled*, 1977 SUP. CT. REV. 171 (1977)	12,13
Cady, *Reasonable Rules and Rules of Reason: Vertical Restrictions on Distributors*, 46 J. MARKETING 27 (1982)	12,14
Caves, "Vertical Restraints as Integration by Contract: Evidence and Policy Implications," in *Impact Evaluations of Federal Trade Commission Vertical Restraints Cases* 429 (R. Lafferty, R. Lande & J. Kirkwood, eds. 1984)	13,16
FTC BUREAU OF ECONOMICS, *Impact Evaluations of Federal Trade Commission Vertical Restraints Cases* (R. Lafferty, R. Lande & J. Kirkwood, eds. 1984)	11
Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1 (1982)	14
Marvel & McCafferty, *The Welfare Effects of Resale Price Maintenance*, 28 J.L. & ECON. 363 (1985)	17
T. OVERSTREET, RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE (1983)	14,16,17,18
Phillips & Mahoney, *Unreasonable Rules and Rules of Reason: Economic Aspects of Vertical Price Fixing*, 30 ANTITRUST BULL. 99 (1985)	9
Posner, *Antitrust Policy and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decisions*, 75 COLUM. L. REV. 282 (1975)	19
Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6 (1981)	18
Posner, *The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision*, 45 U. CHI. L. REV. 1 (1977)	14,17
Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86 (1960)	11

No. 85-1910

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

BUSINESS ELECTRONICS CORPORATION,
Petitioner,

v.

SHARP ELECTRONICS CORPORATION,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE NATIONAL OFFICE MACHINE DEALERS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

INTEREST OF THE AMICUS CURIAE

The National Office Machine Dealers Association ("NOMDA") is a national and international organization representing approximately 6500 office machine dealers. It is recognized as a major spokesperson for the business equipment and systems industry. One of NOMDA's principal organizational goals is to strengthen relationships among manufacturers, dealers and end users. NOMDA provides educational and other important services to its member dealers.

As an organization representing many office machine dealers, NOMDA has a substantial interest in this litigation. NOMDA believes that manufacturers should be able to protect their full service dealers in business equipment and systems by terminating free riders on services that full service dealers provide at substantial cost to themselves. This case involves the treatment of this practice under the Sherman Act. Sharp Electronics Corporation ("Sharp") terminated a retailer who was free riding on costly

services provided by a full service dealer. The free rider, Business Electronics Corporation ("BEC"), diverted customers whom the full service dealer had educated about Sharp's product by offering prices that were lower simply because they did not include any element to compensate for the services that had led to the sale.

Many of NOMDA's members sell complex products of the sort that are most efficiently marketed if the dealer offers prospective purchasers a variety of pre-sale, point-of-sale and post-sale services. This Court's decision in the present case will affect the ability of manufacturers to protect their full service dealers in business equipment and systems by agreeing to terminate free riders on such services. Accordingly, NOMDA has a strong interest in the disposition of this case.

STATEMENT

1. In 1973 Sharp terminated BEC as a Houston-area dealer of Sharp electronic calculators. BEC's marketing strategy had been to offer low prices rather than costly pre-sale educational services. Tr. 72-73; 124-128.[1] Because Sharp's calculators were a new and complex product, BEC's focus on low price at the expense of services that were needed to familiarize potential customers with the product was ineffective, and BEC failed to meet Sharp's sales quotas. Defendant's Trial Exhibit No. 26 (introduced and admitted at Tr. 700). Dissatisfied with BEC's sales performance, Sharp appointed a second dealer in the Houston area, Gilbert Hartwell ("Hartwell"), a full service dealer who offered the pre-sale information services and post-sale support that Sharp believed essential to the efficient marketing of its product. Tr. 343-44; 1031; 1102-03.

BEC took this opportunity to dispense with its entire sales force and to free ride on the services Hartwell provided. Once Hartwell had persuaded a customer to buy a Sharp calculator, BEC diverted the sale by circulating a flier advertising the same product for a lower price—a price Hartwell could not match if he was

1. "Tr." refers to the trial transcript.

to recover the cost of providing the services that produced the sale. Tr. 110; 279-280; 283-284; 343-344; 346-348. Hartwell complained about BEC's free riding to Sharp, Pet. App. at 5a-6a, [2] and Sharp eventually terminated BEC in order to prevent its more effective full service dealer from carrying out its threat to cease selling Sharp's product. *Id.* at 6a.

2. BEC then brought suit against Sharp, alleging that it had been terminated because of its price cutting and that the termination was illegal *per se* under section 1 of the Sherman Act, 15 U.S.C. § 1. The district court instructed the jury to find for BEC if Sharp had acted pursuant to an understanding or agreement with Hartwell to terminate BEC because of its price cutting. Pet. App. at 6a-7a. The jury returned a verdict of $600,000 in favor of BEC. The United States Court of Appeals for the Fifth Circuit reversed and remanded, holding that the district court's instruction to the jury had been improper. The court of appeals held that only agreements between a manufacturer and distributor that require the distributor "to set its prices at some level" so that it does not "retain complete freedom to set whatever price it chooses" are illegal *per se* as price fixing agreements. Pet. App. at 13a-14a.

The Fifth Circuit noted the importance under this Court's precedents of distinguishing between agreements to fix prices, which are illegal *per se*, and nonprice agreements such as an agreement to terminate a dealer because of its free riding, which are judged under the rule of reason. Pet. App. at 10a-11a. Because business uncertainty is created by any method of distinguishing these various agreements that depends upon an analysis of the manufacturer's subjective motives, the court adopted a rule that focuses on the content of the agreement and thereby provides meaningful guidance for manufacturers. *Id.* at 12a.

2. "Pet. App." refers to the Petition for Writ of Certiorari which contains the majority and concurring opinions of the court of appeals. These opinions are also reported in *Business Elecs. Corp.* v. *Sharp Elecs. Corp.*, 780 F.2d 1212 (5th Cir. 1986), *cert. granted*, 107 S. Ct. 3182 (1987).

SUMMARY OF ARGUMENT

A.

Because dealers are a key link in the chain of product distribution, the sales practices they adopt greatly affect the competitiveness of the market, manufacturers' sales levels and end user satisfaction with their purchases. Responsible dealers recognize that they benefit manufacturers and end users alike if they offer sales-related services, such as product information. Free riders threaten the provision of such services by depriving more responsible dealers of the sales their services have generated.

NOMDA's motto is "Service and Integrity." Without these two important elements, a dealer does not properly serve its customer. The sale is only one aspect of the transaction. Service and integrity both before and after the sale ensure end user satisfaction. The free rider does not meet these obligations to the customer. It is therefore essential to the efficient operation of the distribution system that manufacturers have the discretion to protect their full service dealers by terminating free riders.

This Court's decisions establish that vertical agreements generally are judged under the Sherman Act pursuant to the rule of reason. A rule of *per se* illegality is applied only in exceptional circumstances, when experience has shown that a type of agreement is always or almost always anticompetitive and without redeeming economic virtues.

This Court has treated as *per se* illegal only those agreements that set the prices a dealer must charge, that is, agreements that restrict a dealer's price flexibility. Any extension of the scope of the *per se* rule beyond such agreements must depend on a showing that a type of agreement is almost invariably anticompetitive. Economic analysis demonstrates, however, that agreements to terminate free riders enhance marketing efficiency and stimulate intrabrand and interbrand competition.

B.

Efficient marketing of many products requires that dealers provide pre-sale, point-of-sale and post-sale services. For example, new or complex products must be promoted with point-of-sale information services. Dealers have no incentive to offer costly services unless they enhance marketing efficiency and satisfy consumer preferences.

Dealers who provide services must recapture their cost in the price at which they sell. This leaves full service dealers subject to free riding by dealers who do not provide services themselves. Free riders divert customers whom full service dealers have educated about a product by offering the product at a lower price. If free riders operate in a market, soon no dealer will find it worthwhile to offer costly (but efficient) services. Dealers will cease to offer services in order to be able to compete on price terms with the free riders. Free riding therefore jeopardizes the provision of efficiency-enhancing sales-related services. One way a manufacturer can protect its full service dealers and assure the continued provision of needed services is by restricting dealer locations, a practice to which this Court applied the rule of reason in *Continental T.V., Inc.* v. *GTE Sylvania Inc.*, 433 U.S. 36 (1977). Another method of achieving exactly the same result is to terminate free riders.

Agreements to terminate a free rider promote interbrand competition. They induce investment in the provision of services necessary to the efficient marketing of many products, thus permitting manufacturers to compete more effectively. Any price increases that may result indirectly from the termination of free riders are pro-competitive, since they enable dealers to offer services that stimulate interbrand competition.

The termination of free riders also encourages intrabrand competition, as dealers compete on nonprice terms by providing better services. Alternatively, dealers who can offer services at lower cost may be able to shade their prices, thereby engaging in an efficient form of intrabrand price competition.

Because an agreement to terminate a free rider enhances marketing efficiency by ensuring that the optimum level of sales-related services is provided, and because it promotes interbrand and intrabrand competition, it has none of the economic characteristics that have led this Court to hold restraints of trade unlawful *per se*. An agreement to terminate a free rider is a nonprice restriction, properly judged under the rule of reason.

ARGUMENT

THE LEGALITY OF AN AGREEMENT TO TERMINATE A FREE RIDING RETAILER SHOULD BE JUDGED BY THE RULE OF REASON

Dealers are a key link in the chain of product distribution. Vigorous competition in the marketplace, manufacturers' success in marketing their products, and end users' satisfaction with their purchases all depend on the sales practices dealers adopt. Responsible dealers recognize that their role begins before, and continues after, a sale is made. They recognize that they generate more sales and give customers greater satisfaction if they educate potential purchasers about products prior to making a sale and provide repair and other services afterwards. Dealers are hamstrung in their efforts to provide these beneficial services by free riders, who offer no services themselves. Instead, free riders divert buyers who have taken advantage of another dealer's services, offering prices that are lower because they do not reflect the true cost of making the sale. By depriving dealers of sales generated by services offered at significant cost to themselves, free riders threaten the continued provision of services, and hence the efficient operation of the distribution system. Responsible dealers are therefore rightly concerned about free riding, and about preserving the discretion of manufacturers to protect full service dealers by terminating free riders.

Petitioner BEC and its supporting *amici* have presented an argument to this Court that simply begs the question. They label the conduct of respondent Sharp as "price fixing" and then proceed to cite long lists of cases that condemn price fixing as illegal

per se. That sterile exercise in labeling is out of harmony with this Court's recent decisions. These decisions make it clear that *per se* rules should *not* be applied absent a careful analysis demonstrating that the practice at issue is always or almost always injurious to competition and economic efficiency. Analysis of the effects of terminating free riding retailers clearly shows that such terminations promote efficient and vigorous competition in the marketplace. If accepted, petitioner's sweeping expansion of the *per se* prohibition against price fixing would seriously undermine efficiency in product distribution to the ultimate detriment of the American end user.

A. Determining Whether An Agreement Is To Be Judged Illegal *Per Se* Or Analyzed Under The Rule Of Reason Requires Careful Consideration Of Its Economic Effects.

This case brings into focus the basic economic fact that dealers cannot offer sales-related services—even though they promote competition, increase sales and end user welfare—unless dealers can recover the cost of providing those services in the prices they charge. Free riders threaten a dealer's ability to recover the cost of services provided and hence the continued provision of services. Free riders divert customers by offering prices that are lower simply because they include no element of compensation for the services that persuaded the customer to buy. Competing dealers are forced to stop offering costly services so that they can match the free riders' prices, or to stop distributing the affected product altogether.

When Sharp terminated BEC as a dealer in electronic calculators, it eliminated a retailer who was free riding on another dealer's investment in services. It did so, moreover, in a situation where the full service dealer, Gilbert Hartwell, had made it plain that continued free riding would force him to stop carrying Sharp's calculators, leaving Sharp with *no* Houston area dealer to provide information and services needed for the efficient and competitive marketing of Sharp's new and complex product. BEC nevertheless claims that the alleged agreement between

Sharp and Hartwell that Sharp would protect its full service dealer by terminating BEC was a *per se* illegal price fixing agreement under section 1 of the Sherman Act, 15 U.S.C. § 1.

This Court's prior cases, however, have established "the 'rule of reason' as the prevailing standard of analysis" under section 1 of the Sherman Act. *Continental T.V., Inc.* v. *GTE Sylvania Inc.*, 433 U.S. 36, 49 (1977). A court applying the rule of reason considers all the effects of a particular agreement before ruling that it should be prohibited because its net effect is to "suppress or even destroy competition." *Chicago Board of Trade* v. *United States*, 246 U.S. 231, 238 (1918). This favored rule of reason analysis gives way to the application of *per se* rules of illegality only in exceptional circumstances, where experience shows that a practice has such a "pernicious effect on competition and lack of any redeeming virtue," *Northern Pacific Railway* v. *United States*, 356 U.S. 1, 5 (1958), that instances of the practice that do not have an anticompetitive effect "are not sufficiently common or important to justify the time and expense necessary to identify them." *Sylvania*, 433 U.S. at 50 n.16. *See also Broadcast Music, Inc.* v. *Columbia Broadcasting System*, 441 U.S. 1, 19-20 (1979) (in determining if the *per se* rule applies, the Court's inquiry "must focus on whether the effect and . . . purpose of the practice are to threaten the proper operation of our predominantly free-market economy—that is, whether the practice facially appears to be one that would always or almost always tend to restrict competition and decrease output . . . or instead one designed to 'increase economic efficiency and render markets more, rather than less, competitive'").

BEC argues that an agreement between a manufacturer and dealer that a free riding dealer should be terminated is one of the narrow group of practices that this Court has determined under the *Northern Pacific* standard to be *per se* illegal. BEC's argument proceeds by simply labeling such an agreement "price fixing," and then pointing out that price fixing has been considered *per se* illegal since *Dr. Miles Medical Co.* v. *John D. Park & Sons Co.*, 220 U.S. 373 (1911). This Court, however, has refused to

decide antitrust cases by affixing simplistic labels to practices with complex economic effects. *See Broadcast Music, Inc.*, 441 U.S. at 8-9. It engages, rather, in a "functional antitrust analysis," focusing on the economic consequences of a practice. *Sylvania*, 433 U.S. at 46-47. Only such an analysis can show whether a given agreement or type of agreement is properly condemned on a *per se* basis. *Id.* at 58-59 ("departure from the rule-of-reason standard must be based upon demonstrable economic effect"). *See also* Phillips & Mahoney, *Unreasonable Rules and Rules of Reason: Economic Aspects of Vertical Price-Fixing*, 30 ANTITRUST BULL. 99, 101 (1985). Analyzing the function and economic effects of an agreement to terminate a free rider demonstrates that they are very different from the function and effects of vertical agreements this Court has held to be illegal *per se*; the label BEC attempts to attach to Sharp's alleged agreement with Hartwell is a totally inappropriate one.

This Court's past cases have treated as *per se* illegal only those agreements that set the prices a dealer must charge, that is, agreements that restrict a dealer's flexibility in deciding what prices to charge.[3] In *Monsanto Co.* v. *Spray-Rite Service Corp.*, 465 U.S. 752, 761 (1984), this Court noted the "important distinction in distributor-termination cases . . . between concerted action to set prices and concerted action on nonprice restrictions," stating that only the former are illegal *per se* while the latter are judged under the rule of reason. The evil addressed by the rule prohibiting vertical price fixing—as the term itself denotes—is the distributor's agreement that it will "conform[] to the [manufacturer's] suggested price," *id.* at 764 n.9, so that the distributor is "not making independent pricing decisions." *Id.* at 762.

---

3. Contrary to BEC's contention, BEC Br. at 36-38, congressional criticism of the Vertical Restraints Guidelines issued by the Department of Justice, *see* Pub. L. No. 99-180, § 605, 99 Stat. 1136, 1169-70 (1985), does not undercut this view of the scope of the *per se* rule against price fixing. As the Government noted in its amicus brief at the the certiorari stage in this case, U.S. Br. at 11 n.12, congressional criticism was apparently directed not at the Justice Department's view of the scope of the rule, but at its view of the evidence necessary to prove an agreement to fix prices. Congress has not, of course, amended the antitrust laws to embody this criticism.

Thus, in *United States* v. *Colgate & Co.*, 250 U.S. 300, 307 (1919), the Court quashed an indictment that failed to charge Colgate "with selling its products to dealers under agreements which obligated the latter not to resell except at prices fixed by the company." *See also Albrecht* v. *Herald Co.*, 390 U.S. 145, 150 (1968) (striking down a combination to force retailers "to conform to the advertised price"); *United States* v. *Parke, Davis & Co.*, 362 U.S. 29, 46 (1960) (striking down a "program to effectuate . . . retailers' adherence to . . . suggested retail prices"); *United States* v. *A. Schrader's Son, Inc.*, 252 U.S. 85, 99 (1920) (noting the "obvious difference" between a manufacturer indicating his wishes concerning prices and an agreement binding dealers "to observe fixed resale prices").

The limitation of the *per se* rule against vertical price fixing agreements to those agreements that restrict dealer price flexibility is an inevitable consequence of this Court's focus on the economic effects of vertical agreements. As we demonstrate below, economic analysis shows that, like the dealer location agreements to which the Court applied the rule of reason in *Sylvania*, agreements to terminate free riders have substantial beneficial economic effects, enhancing efficiency in a number of ways. Far from restraining competition, such practices stimulate nonprice competition without restricting dealers' ability to compete efficiently on price terms.

B. Termination Of Free Riders Improves Efficiency By Ensuring The Continued Provision Of Essential Sales-Related Services.

The economic substance of agreements to terminate free riders is that they are nonprice restrictions on the way retailers market a manufacturer's products. Such agreements help manufacturers ensure the efficiency of their distribution systems by guaranteeing that sales-increasing services will be provided by dealers; they protect dealers' investments in the provision of services from free riders; and they benefit end users by ensuring the availability of services needed to make informed purchasing decisions.

1. *Pre-Sale Educational Services.* The sales process is not usually complete with a simple sale. The efficient marketing of many products requires that dealers provide services, both before and after the sale. Before a sale, full service dealers provide information about a product; after a sale, they stand behind the products they carry, providing repair facilities and information support.

Dealers offering pre-sale informational services educate potential purchasers about a product's qualities and capabilities and explore with end users the fitness of the product for particular purposes. The need for dealers to promote products through pre-sale informational services is particularly acute in the case of complex items such as computers, business equipment and systems, household electronic goods, and video or audio equipment. The electronic calculators manufactured by Sharp in 1973 fall into this category. End users could not appreciate the advantages of particular products of this type and could not make informed purchasing decisions unless they receive specialized information. Tr. 113-14; 343-46; 1429-39.

Pre-sale information services are also particularly necessary for the products of a new market entrant, and for new products in general. New products, unfamiliar to the mass of end users, must be introduced to them and their advantages explained, if the product is to gain end user acceptance. *See* Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86, 95 (1960).[4] Beyond these special cases, *any* product with characteristics the end user cannot readily evaluate through simple

4. FTC-sponsored studies of the impact of vertical restraints have found protection of dealers from intrabrand competition so important in these situations that the FTC concluded that even resale price maintenance—price fixing—"was beneficial for consumers and for society as a whole when used early in the product's life cycle and when used by new [market] entrants." FTC BUREAU OF ECONOMICS, "Introduction and Overview," in *Impact Evaluations of Federal Trade Commission Vertical Restraints Cases* 1, 30 (R. Lafferty, R. Lande & J. Kirkwood, eds., 1984). This Court in *Sylvania* also noted that one of the ways in which manufacturers entering new markets could use vertical restrictions in order "to compete more effectively against other manufacturers" was to apply restrictions "to induce competent and aggressive retailers to make

(footnote continued on following page)

examination will be more effectively marketed if the dealer offers services to educate the end user about the product.

Pre-sale information services have efficiency effects beyond promoting sales. End users benefit directly from such services because they increase the likelihood that end users will purchase products that meet their requirements. End users also benefit indirectly because the services promote efficient distribution, thus reducing distribution costs that are included in the purchase price. The general allocative efficiency of the economy also is furthered; the choices informed end users make translate into profits or losses for manufacturers, with the net result that manufacturing output tends to move towards products that informed end users desire. *See* R. BORK, THE ANTITRUST PARADOX at 91 n.* (1978).

Pre-sale services will not be provided except when these beneficial effects are expected to follow. If the provision of services does not "increase the demand for a manufacturer's product more than enough to offset any reduction in demand resulting from the higher distribution margin necessary to compensate for them . . . they generally will not be provided." Cady, *Reasonable Rules and Rules of Reason: Vertical Restrictions on Distributors*, 46 J. MARKETING 27, 31 (1982). Furthermore, the services, if offered, can safely be assumed to satisfy consumer preferences, for "[a] manufacturer has no incentive to provide service for which the utility to the consumer does not equal or exceed the cost of providing it, since to do so would simply reduce demand for the manufacturer's product." *Id.*

Detailed information is usually provided most effectively by the dealer. "The more detailed the information, the more efficient it will be to provide it at the point of sale to persons who have identified themselves as potential buyers and who . . . may have questions not easily anticipated and addressed in mass market advertising." Bork, *Vertical Restraints: Schwinn Overruled*,

---

(footnote continued from previous page)
the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumer." *Sylvania*, 433 U.S. at 55.

1977 SUP. CT. REV. 171, 181 (1977). But the dealer must make a significant investment if he is to provide this service. He must hire trained sales staff and frequently, because it takes time to impart information to customers, hire more staff than would otherwise be necessary. The dealer will need demonstration models and personnel trained to operate and explain them. He may also engage in local advertising. Part of the information package offered by the dealer will include displaying a full range of a manufacturer's products, requiring ample (and hence costly) display space. *Id.*

2. *The Free Riding Phenomenon.* A dealer who provides these efficiency-enhancing pre-sale services must recapture their cost in the price at which the dealer sells. *See Monsanto*, 465 U.S. at 762-763; Bork, *Vertical Restraints: Schwinn Overruled*, 1977 SUP. CT. REV. at 181. For this very reason, full service dealers are subject to free riding by dealers who do not provide services themselves and so can sell the same products for less. "[S]ome dealers will perceive that they can let others incur the costs of persuasion and capture the customer by offering a lower price. Such dealers take a free ride." Bork, *Vertical Restraints: Schwinn Overruled*, 1977 SUP. CT. REV. at 181. The customer in this situation "has an incentive to absorb the information [offered by the full service dealer] and then to decamp for the nearest discount store and purchase the same article at a price not incorporating its cost of provision." Caves, "Vertical Restraints As Integration By Contract: Evidence And Policy Implications," in *Impact Evaluations, of Federal Trade Commission Vertical Restraints Cases* 429, 433 (R. Lafferty, R. Lande & J. Kirkwood, eds., 1984).

Customer benefits stemming from the presence of free riders—getting both the information and low price that they want—are short lived. If free riders undercut full service dealers, soon no dealer finds it worthwhile to offer costly pre-sale, point-of-sale and post-sale services. These services will simply disappear as dealers become unable to afford to provide them.

See T. OVERSTREET, RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE at 49 (FTC Bureau of Economics Report 1983) (free riding causes "the unfettered market to underprovide valuable services or not to provide them at all"). "This situation reduces consumer welfare since desired services cannot be obtained. It reduces manufacturers' [and dealers'] welfare because sales revenue and profit are reduced." Cady, *Reasonable Rules and Rules of Reason: Vertical Restrictions on Distributors*, 46 J. MARKETING at 31.

Of course, free riding also jeopardizes the other benefits noted above that result from the provision of sale services. The development of new products, for example, may be deterred. This occurs because pre-sale services are essential to creating a market for new producers and products. If a competing dealer is able to free ride on expensive market development services offered by a full service dealer, manufacturers may find it difficult to persuade *any* dealer to offer those services. "A distributor will refrain from making the required initial investment [in promotion and market development] if there is a reasonable probability that a competitor can benefit from its market development activities before the costs of undertaking those efforts have been recouped and normal returns obtained." *Id.* at 32. It follows that free riding may have the anticompetitive effect of chilling the marketing, and hence the development and manufacture, of new products.

To "evoke the optimal level of dealer presale services" manufacturers must be able to protect full service dealers from competing free riders. Posner, *The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision*, 45 U. CHI. L. REV. 1, 6 (1977). Manufacturers must be able to assure "dealers that the fruits of product-connected services they provide [cannot be] usurped by cut-rate, no-frills competitors." Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1, 2 (1982).

3. *Protection of Full Service Dealers.* One way to protect a full service dealer from unfair intrabrand competition from free riders is for a manufacturer to limit the number and location of

retailers of its products, a method held in *Sylvania* to be subject to the rule of reason test. Another method, however, is for the manufacturer to terminate dealers who free ride. The termination of free riders, just like the restriction of dealer locations in *Sylvania*, eradicates inefficient intrabrand competition that threatens to curtail the optimum level of service. Indeed, this Court explicitly recognized in *Sylvania* that the vertical restriction there in issue was one way the manufacturer could attempt to overcome free riding that endangered optimum service levels. As the Court stated, "[b]ecause of market imperfections such as the so-called 'free rider' effect, [services that promote efficiency] might not be provided by retailers in a purely competitive situation." *Sylvania*, 433 U.S. at 55. To draw a distinction for Sherman Act purposes between the dealer location and dealer termination methods of counteracting free riding would be to make a distinction "essentially unrelated to any relevant economic impact"—the very ground upon which the *Sylvania* Court found *United States* v. *Arnold, Schwinn & Co.*, 388 U.S. 365 (1967), to be defective. *Sylvania*, 433 U.S. at 56.

The present case exemplifies the free riding problem described above and acknowledged in *Sylvania*. Sharp's new, complex and unfamiliar product competed with electro-mechanical calculators that had an established market. Tr. 356; 358-59. Sharp could only succeed in the face of this competition if its dealers educated potential buyers about their product by offering extensive pre-sale services. The record shows the substantial amount of informational services that were required: a dealer usually had to make four or five sales calls on a customer before that customer bought a Sharp calculator. Tr. 113-114; 343-348; 1429-1432. BEC did not provide these pre-sale services. Tr. 72-73; 124-128. Inevitably, BEC's sales of Sharp calculators were much lower than Sharp desired. *See* Defendant's Trial Exhibit No. 26 (introduced and admitted at Tr. 700).

Hartwell, on the other hand, was a full service dealer. He offered the sort of services necessary to stimulate demand for Sharp's new product through his trained sales staff. Tr. 343-344;

1031; 1102-1103. In this classic free rider situation, BEC dispensed with its sales force, stopped advertising, and diverted prospective buyers whom Hartwell had given costly education by circulating fliers offering the same products at prices that were lower—precisely because BEC did not need to pay for pre-sale services. Tr. 110; 279-280; 283-284; 343-344; 346-348. Of course, Hartwell could not compete in this situation and so advised Sharp. Sharp therefore was compelled to act decisively to assure that the services necessary to market its product would continue to be offered to consumers. Its termination of BEC was a rational, efficiency-enhancing, and pro-competitive response to protect its full service dealer from unfair competition from BEC that was disrupting Sharp's marketing strategy.[5]

C. Termination Of Free Riders Prevents An Inefficient Form Of Marketing While Promoting Vigorous Competition.

Conduct is held *per se* illegal under section 1 of the Sherman Act only when it is "manifestly anticompetitive." *Sylvania*, 433 U.S. at 50. The termination of free riders, however, as shown above, eradicates an *inefficient* form of competition—competition that relies on the provision of services by another dealer and so endangers the continued availability of those efficiency-enhancing services. It does not, however, reduce *efficient* forms of competition.

1. *Interbrand Competition.* In determining what vertical restraints are *per se* illegal, this Court has paid special attention to the effect of those restraints on interbrand competition. *See*

5. Dealers may offer many other services, in addition to pre-sale information, that expose them to free riding. One of the most important is repair service that cannot be priced at full cost. *See* Caves, "Vertical Restraints as Integration by Contract: Evidence and Policy Implications," in *Impact Evaluations of Federal Trade Commission Vertical Restraints Cases* at 433-34. Another is the projection of an image of quality for products carried, through shopping environment, sales methods, refund policies and other services. *See* T. OVERSTREET, RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE at 56-58. Customer support in the form of technical information and problem-solving techniques also, in NOMDA's experience, exposes dealers to free riding.

Sylvania, 433 U.S. at 51-57 (relying on the increase in interbrand competition created by dealer location restrictions); Posner, *The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision*, 45 U. CHI. L. REV. at 5 (in *Sylvania*, the Court endorsed "the primacy of interbrand competition" in the analysis of vertical restraints).

Agreements to terminate a free rider promote interbrand competition. Just like the dealer location restrictions in *Sylvania*, termination of free riders permits a manufacturer "to compete more effectively against other manufacturers." *Sylvania*, 433 U.S. at 55. By terminating free riders, a manufacturer of new products can "induce competent and aggressive retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumer." *Id.* And "[e]stablished manufacturers can ... induce retailers to engage in promotional activities or to provide service and repair facilities necessary to the efficient marketing of their products." *Id.*

Furthermore, the classical explanation for the potential anticompetitive interbrand effect of vertical price fixing has no application in the case of the termination of a free rider. Vertical price fixing has been said to be anticompetitive because it facilitates horizontal cartelization at the manufacturer level by easing the burden of cartel policing: fixed prices "enhance[] the likelihood of detecting manufacturer price shading," i.e., cheating on the cartel. T. OVERSTREET, RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE at 21 (emphasis omitted). *See also* Marvel & McCafferty, *The Welfare Effects of Resale Price Maintenance*, 28 J. L. & ECON. 363, 365 (1985). An agreement to terminate a free rider can have no such detrimental effect on interbrand competition. Absent a separate agreement to reduce dealer price flexibility, an agreement that a free rider should be terminated leaves remaining dealers free to follow the manufacturer's recommended retail prices or not, as the dealers see fit—a fact illustrated in this case, where Hartwell did not always follow Sharp's suggested retail

prices, and did not believe himself to be obligated to sell Sharp's calculators at any particular price. Pet. App. at 6a. The dealer who is a party to the agreement is free to vary its prices in response to market conditions including, most obviously, competition from other products.

Moreover, termination of a free rider in no way gives full service dealers free rein to raise prices. Interbrand competition remains a potent disincentive to raising prices; and interbrand competition will continue after the elimination of free riders to keep profit margins low. *See* Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6, 16 (1981).

It is clearly not enough to condemn an agreement to terminate a free rider that one of its indirect effects may be to enable remaining retailers to raise their prices within limits imposed by interbrand competition. First, any price increases that indirectly result from such an agreement are actually pro-competitive, since they enable dealers to offer the very services that, as this Court noted in *Sylvania*, stimulate interbrand competition. Relieved of pressure from free riders continually undercutting a dealer, that dealer may increase its prices to the level necessary to provide customers with the mix of information and services that the dealer and manufacturer believe will result in the most effective distribution.

Second, any expansive definition of "price fixing" to include agreements potentially having an indirect impact on prices would be "flatly inconsistent with *Sylvania*," because, as the court of appeals in this case recognized, *see* Pet. App. at 9a, "[v]irtually all of the justifications for vertical nonprice restrictions endorsed in *Sylvania* assume an indirect effect on price." *See generally* Baker, *Interconnected Problems of Doctrine and Economics in the Section One Labyrinth: Is Sylvania a Way Out?*, 67 VA. L. REV. 1457, 1467 (1981). *Accord* T. OVERSTREET, RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE at 39 n.1. It follows that this Court's observation in the horizontal restraint context is equally applicable to

vertical agreements: "Not all arrangements . . . that have an impact on price are *per se* violations of the Sherman Act or even unreasonable restraints." *Broadcast Music, Inc.* v. *Columbia Broadcasting System*, 441 U.S. at 23.

2. *Intrabrand Competition.* Free rider termination removes an inefficient form of intrabrand competition—competition based on the free rider's lack of provision for services at the expense of the full service dealer—but it does nothing to lessen other efficient forms of intrabrand competition. Terminating a free rider leaves the door open for established full service dealers to compete with each other on both price and nonprice terms, and for new dealers to enter the market.[6]

Insofar as dealers may offer different styles or types of services, or be able to provide the same service at a lower cost, they will be able to shade prices and stimulate intrabrand price competition. That price competition, however, focuses on dealers' efficiency in providing necessary services, and not on mere free riding on services provided by others. Alternatively, dealers may compete on nonprice terms, increasing "the provision of point-of-sales services . . . to engross as much as possible of the difference between the retail price . . . and the (old) cost of distribution[,] spending more and more money on nonprice competition until the marginal cost of distribution has risen to meet the [dealer's] price." Posner, *Antitrust Policy and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decisions*, 75 COLUM. L. REV. 282, 284 (1975). *See also Valley Liquors, Inc.* v. *Renfield Importers, Ltd.*, 678 F.2d 742, 745 (7th Cir. 1982) (noting that "[t]he elimination of a price cutter who is taking a free ride on the promotional efforts of competing distributors will tend to stimulate nonprice competition among the distributors").

---

6. In fact, free rider termination may for these reasons be considerably less restrictive of intrabrand competition than dealer location arrangements of the sort to which this Court applied the rule of reason in *Sylvania*. If one assumes limited end user mobility, a dealer location restriction may create a local monopoly and leave at least some dealers without *any* intrabrand competition whatsoever.

NOMDA concludes that, since an agreement to terminate a free rider has tangible efficiency-enhancing effects and stimulates intrabrand and interbrand competition, it is not the economic equivalent of a naked agreement to fix prices, and it does not thereby restrict dealer price flexibility. Such agreement to terminate a free rider shares none of the economic characteristics or effects that have led this Court to hold various agreements unlawful *per se*. NOMDA therefore urges this Court to affirm the court of appeals' conclusion that an agreement to terminate a free rider belongs to the only other category of vertical restrictions identified in *Monsanto*—"concerted action on nonprice restrictions," 465 U.S. at 761—and that these agreements must be analyzed under the rule of reason.

Responsible dealers would welcome a decision in this case recognizing that their provision of services is essential to the efficient operation of the distribution system, with benefits for manufacturers and end users alike. Because dealers cannot long continue to offer pre-sale, point-of-sale and post-sale services in markets in which free riders operate and profit at their expense, this Court should act in this case to protect the integrity of the distribution system by preserving the discretion of manufacturers to terminate free riders.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

/S/ SAMUEL SCHOENBERG

SAMUEL SCHOENBERG
Counsel of Record
ROBERT D. GOLDBERG
General Counsel
National Office Machine
Dealers Association
222 South Riverside Plaza
Suite 2700
Chicago, Illinois 60606
312/648-2300

Dated: November 6, 1987